Investment Report: Q2, 2010

Market Summary

The second quarter of 2010 was characterised by weak returns from real assets (Figure 1). The primary catalyst was a severe deepening of the economic and fiscal crisis in Europe. This brought the return of systemic risk and this is never good for investments that depend on a normal, functioning economy and financial system. No surprise then that government backed securities and the $ - the classic defensive currency – saw strong gains. Property prices tend to exhibit a lag on events and the rise in Q2 should be seen in that context. Most impressively, corporate credit delivered positive returns as investors continue to crave secure yield bearing investments.

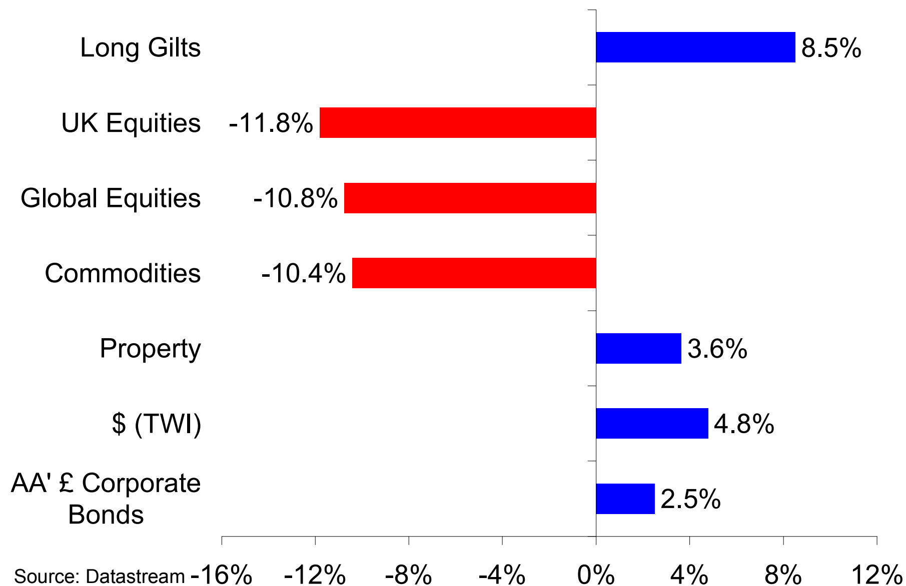

Figure 1: Market Performance – Q2, 2010 (total return)

Since the end of Q2, the picture has changed (Figure 2) albeit at the time of writing risk markets have started to settle back. Stability in Europe – delivered largely by an immense support package by the ECB, EU and IMF, saw concerns over a generalised implosion ebb away. In their place we have seen issues, of a more cyclical nature, arise involving the US. The economic recovery of 2009/10 appears to be faltering.

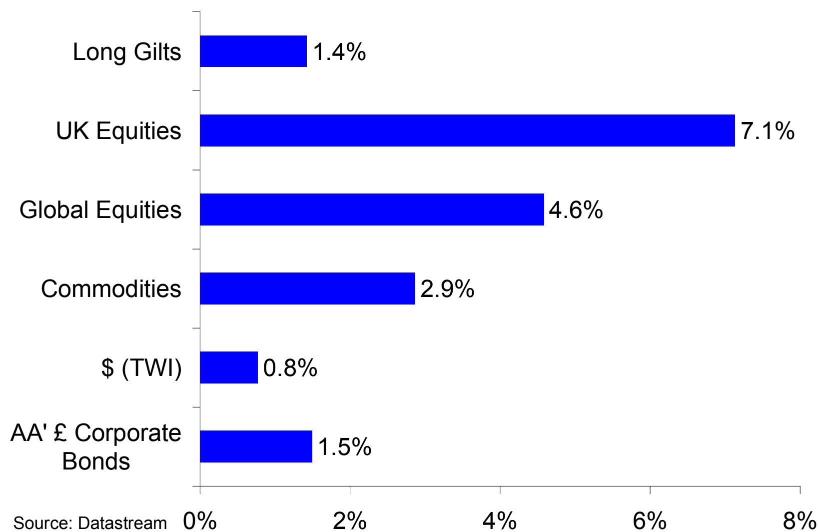

Figure 2: Market Performance – end June to 13th August

Market Observations

We remain in an economic and market environment for which there is scarce precedent in living memory. The journey back to normal conditions remains challenging.

Figure 3 once again highlights that slope of the US yield curve (a proxy for all others) is incredibly steep but has started to exhibit 'natural' flattening. The current steep slope usually portends of economic strength and developing pressure on inflation which encourages central banks to respond by raising official interest rates. Yet policy rates, across the major economies, remain at emergency levels – with no immediate sign of changing. Flattening of the yield curve without any move higher in official rates will be very bad news for pension schemes as liability values increase sharply without a corresponding improvement in economic conditions.

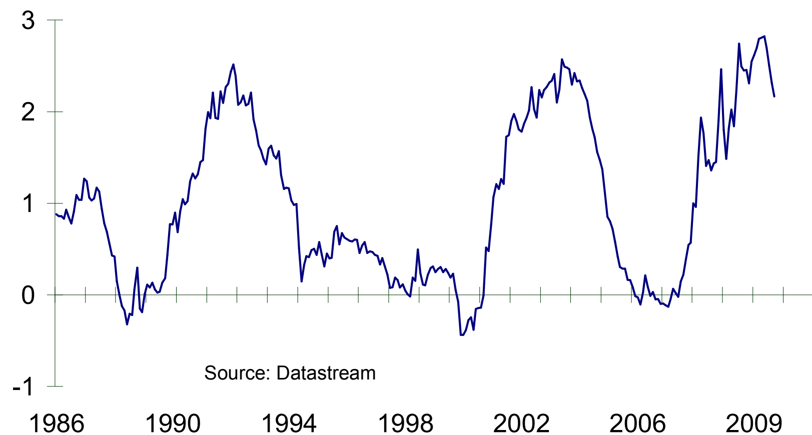

Figure 3: US yield curve (ten-year yields less two-year yields, %)

Once again, asset markets are seeing investment performance polarise – all risk assets rising together or falling together; this is one reason offered why the performance of hedge funds has been disappointing recently. The 'safety vale' in such situations is often found in the foreign currency exchanges. Figure 4 highlights this effect; currencies are exhibiting, by their standards, large swings. These oscillations in relative competitiveness are partly the response of policy direction – currency debasement being an explicit objective – and are never constructive for industry – no one likes instability.

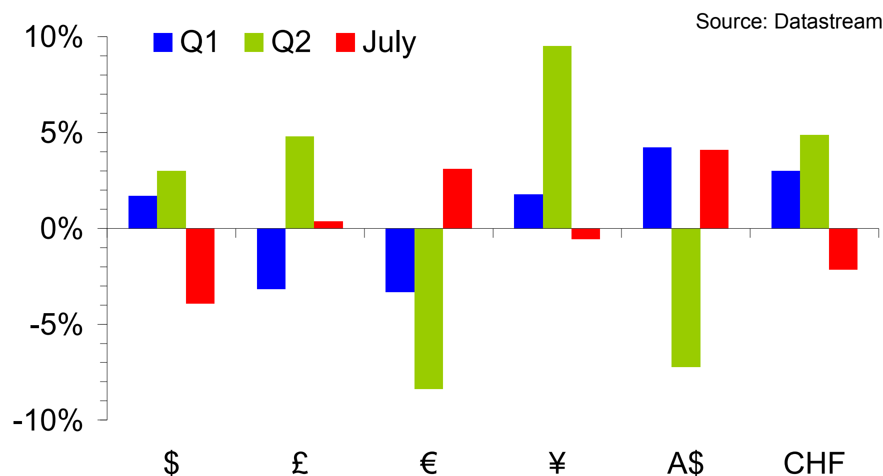

Figure 4: Change in selected trade weighted currency indices

If yield curves continue to flatten as described then stresses and strains within the financial economy are set to continue; wild currency swings will persist.

Commentary

One of the many intriguing features of the current market environment is that equity risk premiums (ERPs) remain very elevated. UK ERP is where it was last August and US ERP where it was in April 2009. The market is struggling to come to terms with an environment where it is possible that risk premiums remain elevated, at least compared to the norm of the last two decades or more.

One factor driving this may be the ongoing involvement of the government, broadly defined, in financial markets: $15 trillion of money printing, Government spending and guaranteeing that has been thrown at the financial crisis and its aftermath. Indeed, one reason for the recent decline in bond yields is a widespread view that the next stage in the battle is for "QE2" to be unveiled by the Fed – see insert. QE is sparking a vigorous debate about whether it will lead to inflation or will be powerless to stop deflation. Both inflation (persistently above 4% or so), and deflation are very bad for asset prices. If the market is convinced that QE will produce only one of those two outcomes then it could be raising risk premiums even as asset prices rise.

Other government interventions are likely to be unwelcome. During the time of the Asian financial crisis, Malaysia went down the route of capital controls. By some measures, the policy worked. Malaysia had a relatively shallow recession and it was one of the first Asian economies to emerge from the crisis. There has to be some concern that if there is further turbulence in markets, that some form of protectionist response, perhaps impeding the free movement of capital, is possible. There have already been several random rule changes imposed on markets at various points in the last two years, the latest of which was the ban on naked short selling by Germany at the height of the sovereign crisis in May.

The market is aware that the banking industry, broadly defined, is under threat from increased regulation. The US Congress has passed a Finance Bill that overhauls regulation of Wall Street. Basel 3 waits in the wings and the "one-off" bonus tax in the UK looks like becoming a semi-permanent feature of the tax base.

We are a long way from the one-way trade from the early 1980s onward where de-regulation and liberalisation were the desired policies of governments around the world. It would seem likely that the shift back toward more regulation and less liberalisation could also be a multi-year process. The hangover from the Great Recession therefore retains considerable policy uncertainty.

The other "secular" feature is the increased recognition that emerging markets have an increasingly important role to play in the global economy; note the move from the G7 being the primary discussion forum for global policy makers to the G20. This has implications for setting asset prices. It used to be the case that the US economy was a proxy for the world. With well over a hundred years of uninterrupted data, it was relatively straightforward to develop a reaction function to US dataflow and policy that was rooted in what had worked in past cycles.

This is the first cycle being driven by more than just what is going on in the US. Emerging equities have been outperforming the developed world since November 2008. It may well be that given the relative growth profile and the relative health of the banking systems in the two complexes, 'emerging' should trade on a par with 'developed' but, by definition, emerging markets do not have rich histories of data. They are not markets where policy makers have decades of experience of transparent policymaking. Many of them have an attitude to the rule of law that is less than robust. And most of them have dataflow that leaves much to be desired. The ability of the Chinese to produce a GDP growth rate for Q2 two weeks ahead of the US, and to never have to revise that growth rate, being but one example of the opaque nature of emerging market data.

For the above reasons at least one of the hangovers from the Great Recession and financial crisis is therefore likely to be elevated risk premiums. That could be an ongoing depressant for markets even without the much feared double-dip recession.

Insert: QE2

Quantitative easing has become a natural part of the investment lexicon during this financial crisis. Hitherto the object of ridicule in western economies, it has been fully embraced by even the most conservative of central bankers. That said, all those active have put their programmes on pause in recent months. The rapid turnaround in asset markets since March 2009 had encouraged the view that quantitative easing would not return. However, investors have begun to fixate on the likelihood and implications of any resumption of quantitative easing (generally referred to as QE2). As arguably the most dramatic form of monetary policy imaginable, it should be taken seriously.

A policy of deliberately seeking to enlarge the quantity of money in the system - quantitative easing or QE represents the attempt to, quite literally, lead investors to buy assets other than bonds. Central banks achieve this through buying bonds in the open market. When short-term interest rates are zero, the cash received from the bond sales, needs to find a home elsewhere; few investors can hold a yield-less asset for long.

QE broadly has the following aims:

1. to elevate asset prices – it should be noted that the Deputy Governor of the Bank of England specifically highlighted, in 2009, this as a key rationale behind the QE programme operated in the UK;
2. to induce a positive wealth effect on both companies and individuals
3. by capping real bond yields and narrowing credit spreads which helps to improve housing affordability
4. to make it easier for governments to borrow to expand fiscal policy – acting as a buyer of last-resort, the central bank stops private sector investors demanding higher yields in a manner that might lead to a premature tightening of fiscal policy;
5. to lower the value of the currency – leading to improved external competitiveness and encourage exports.

The overtly stimulative nature of QE would naturally, and normally quickly, generate profound inflationary pressures if implemented in a properly functioning economy. The advent of QE is an admission that conventional policy efforts either have been exhausted or have much diminished effectiveness. Without question it reflects a situation where the risks associated with genuine price declines or deflation are significant.

One of the weaknesses of QE is that central banks cannot rely on the sellers of bonds to go ahead and purchase other assets; in the first instance, they are more likely to go and buy more bonds, safe in the knowledge that there is a buyer willing to pay an even higher price. Therefore, it can take some time for the cash to filter into other assets. Given the potential for leakage, quantitative easing has to be administered in huge quantities – it is widely accepted that, should the US proceed with a full resumption of QE, then the authorities will need to purchase $1 trillion of bonds.

The sheer scale of these numbers stretches the minds of many and makes any reversal highly problematic. For example, the US government already owns (or under-writes) 70% of US mortgages. If it were to turn a seller of such securities, potential buyers would evaporate and the market distortions would be immense.

Against this backdrop, and with the UK, US and others having already applied QE1, investors will likely see any resumption as proof that the underlying health of the associated economy is much worse than even the bears fear. At this time, you would get short odds on QE returning in the UK, US, Japan and Europe; its one thing fearing the worst, its quite another to learn that things are worse than you feared.

Strategy Guidance

The Pension Fund is inherently 'long' risk assets. On this basis, any assessment of unexpected events is best biased to the negative.

1. Notwithstanding the rise in equity markets that had taken place, we have not yet extricated ourselves fully from the severe global economic slowdown foretold by a raft of leading economic indicators in 2008/9. Sentiment rallied strongly off the lows last year but has been jolted by the re-emergence of the Credit Crunch at the sovereign level. Alleviated only by a huge emergency support package, investors have enjoyed a reprieve. However, as recent weakness in the US has shown, job creation is extremely weak in the developed economies. The replacement of systemic issues (Europe) by cyclical issues (US) is not without severe risks. A renewed US downturn would inevitably generate a negative feedback onto Europe that would limit the ability of Germany in particular to be strong enough to support the beleaguered southern European states.
2. As highlighted earlier, movements on the foreign exchanges are likely to remain accentuated as national contrasts form a greater part of investor thinking; the € fares badly in any such assessment. The currency of choice (within the developed nations) remains the US$ but it too is not without its challenges. Fiscal retrenchment will limit the ability of £ to move higher but £ remains a more attractive currency than the €. The recommendation to hedge out € exposure remains in force (ideally into $s)
3. Risk mitigation strategies will likely prove crucial in the months ahead, as we are not yet "out of the woods". The investors remain poorly positioned to absorb any fresh decline in assets markets; a sharp rise in liability values is however the more immediate threat. A severe (25+%) sell-off in financial markets is unlikely but the consequences will be more severe simply because of the poverty of remedial policy options. Government bonds are becoming too expensive to hold on any grounds other than risk mitigation; there are better ways off defending portfolios.
4. Despite suggestions to the contrary, official interest rates are set to remain low for some time. Longer dated, forward rates are set to fall further and offer the PF protective potential (risk mitigation). Markets such as Australia and NZ provide the best opportunities. Option strategies may prove an effective means of acquiring protection.
5. Prudence requires that systemic and economic fractures must still be examined for their possible (negative) impact on the PF. Possible areas of specific concern are listed below.
   - A strong move towards greater protectionism still cannot be discounted.
   - Higher commodity prices threaten, once again, to depress disposable incomes and, combined with persistently subdued economic growth, threaten to foster an environment typically characterised as 'stagflation'; this is a poor backdrop for investing generally but specific asset classes, e.g. commodities, can be attractive.
   - Led by moves in developing and commodity economies, risks surrounding extrication from the current emergency monetary policy setting are growing, indeed as the insert discusses, the problems are likely to be compounded.
6. In the face of these risks, the case remains that policymakers will do whatever necessary to rebuild confidence and avoid a sharp economic recession. Against this backdrop risk-free inflation protected assets are ideal if priced attractively. Unfortunately, UK index-linked stocks are very richly priced. Other, more attractive, index-linked markets exist.
7. The multi-year outlook remains that of a broad but ultimately trend-less, trading range for equity markets. Timely, though ideally infrequent, adjustments to the broad asset allocation may be considered; 'contingency' cover will be important.
8. The Panel should not underestimate the scope for extreme currency volatility in the extended period ahead. These moves represent both risk and opportunity to the pension fund; risk should be avoided and opportunities harvested. Re-specification of the Fund's approach to currency risk is essential.